

IRS News Release

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IRS Announces Closing Agreement Program For Forward-Float Agreements Used With Municipal Bonds

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WASHINGTON — The Internal Revenue Service today announced a new Voluntary Closing Agreement Program (VCAP) to address violations of federal tax law on arbitrage investment restrictions. The violations are related to non-fair market value purchases of forward-float investment agreements used in advance refundings of tax-exempt municipal bonds.

This program will be available to municipal bond issuers who wish to correct such violations. A link to a document describing the VCAP, along with a comprehensive example can be found on www.irs.gov/bonds.

The purchase of a forward-float agreement at a yield below fair market value could result in a violation of applicable arbitrage yield restrictions, for which there is generally no “self-correction” vehicle available.

Resolution terms described in this program are only available until March 1, 2008. Failure to correct a violation could result in a related bond issue being deemed “arbitrage bonds,” which lose their tax-exempt status.

“We anticipate that this will be the first of several special compliance programs developed to assist issuers in voluntarily resolving specific violations,” said Clifford Gannett, director of the Tax-Exempt Bonds division of the IRS.

Forward-float investments that meet an existing bidding safe harbor are treated as purchased at fair market value and are therefore not in violation of federal tax law.

Background

Municipal bond issuers can save borrowing costs by refinancing their debt when interest rates decline. However, most municipal bonds can not be redeemed until their 10-year call date.

For bonds that are not yet “callable,” municipal bond issuers can take advantage of a decline in interest rates by undertaking “advance refundings.” They issue new bonds at lower interest rates and hold the proceeds in escrow until the original higher-costing

bonds can be redeemed. An escrow fund is structured to generate a cash flow that matches the debt service requirements of the old bonds.

There may be occasions when permitted investments are not available to exactly match the needed cash flow. For instance, the prior bonds may have debt service requirements each Jan. 1 and July 1 and the closest maturing securities available may have maturity dates of Nov. 15 and May 15, a mismatch of about 45 days.

A tailored investment product, commonly known as a “float agreement” or “forward float agreement” was developed for such situations. In these transactions, the issuer will enter into a float agreement with an investment provider to invest the idle cash during the float periods. Typically, the investment earnings on a float agreement are prepaid to an issuer in a one-time, up-front payment. An issuer benefits by being able to fully invest its escrow fund while still having the ability to compute the yield of the escrow over its entire term.

Yield Burning

The illegal practice of yield burning by securities brokerage firms came to the attention of the IRS and other federal regulators in the mid-1990s. Yield burning is the practice of charging inflated prices in excess of fair market value for escrow securities to artificially comply with yield restrictions. This practice diverted millions of dollars of arbitrage profits from federal, state, and local governments. The underpayment of earnings on a float agreement creates a similar diversion of arbitrage.

Method for Pricing Float Agreements

Because float agreements pertain to cash flows that will occur in the future, they generally are priced using implied forward rates. For purposes of the special VCAP for float agreements, the IRS will determine the fair market value prices of float agreements with a pricing model which uses implied forward interest rates derived from the U.S. Treasury Daily Yield Curve. This is done with certain adjustments for reasonable costs and expenses associated with a float agreement, such as an investment provider’s profit, legal and other administrative costs, and hedging costs. Under this special VCAP, the IRS will treat a float agreement as being purchased at fair market value if it has an upfront payment equal to at least 80 percent of the upfront payment determined under the IRS’s described forward pricing method. This pricing method is described in further detail in a document describing this VCAP which can be found through a link on www.irs.gov/bonds.